Search and Intermediation: Toward a Model of the Merchant Trader *

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Abstract

This paper develops a dynamic model of an exchange economy with intermediation. The focus is on the endogenous choice of homogeneous agents between specializing as producers or as merchants. Each agent can switch occupation each period. Producers search for exchange partners in a decentralized market. Merchants, who cannot produce, set up trading posts. A producer may meet another producer, in which case he must search again in the following period. He may also find a trading post, and with some probability recall its location in the following period.

Each merchant charges a price to mediate trade, and can enforce this price on producers that arrive at her trading post. Clients decide whether to return to a post based on the price.

There are two kinds of equilibria. In "bandit" equilibria, merchants take the entire endowment of producers they meet, who never return. In intermediation equilibria producers return to their merchants if they remember the location. We completely characterize all equilibria in Markov strategies, and investigate their welfare properties. We find that, though small numbers of merchants can increase the efficiency of the economy, equilibrium is often grossly inefficient owing to excessive numbers of merchants.

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